

The following is the Franchise Tax Board's analysis of SB 1234 (Alpert) as amended August 25, 1997.

SUBJECT

Conformity/Check-The-Box Regulations

SUMMARY

This bill would conform to federal entity classification regulations (check-the-box regulations) and would generally provide that whatever classification the taxpayer adopts for federal purposes also must be used for California purposes. This bill would provide special rules for single-member limited liability companies (LLCs) that are disregarded for federal tax purposes.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and apply to taxable or income years beginning on or after January 1, 1997.

BACKGROUND

On December 17, 1996, the Internal Revenue Service released final Treasury Regulations, effective as of January 1, 1997, concerning the classification of business entities for federal income tax purposes (Treas. Reg. Sections 301.7701-1, -2, -3, -4). These regulations, known as the "check-the-box" regulations, significantly modify and simplify the former entity classification rules that were applicable for federal income tax purposes. In general, the regulations allow certain unincorporated entities with two or more members (as defined) to elect tax classification as either a partnership or corporation. In addition, a single-member unincorporated entity may be disregarded as an entity separate from its owner.

SPECIFIC FINDINGS

The Internal Revenue Code (IRC) defines a partnership to include a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and that is not a trust or estate or a corporation. The IRC defines a corporation to include associations, joint-stock companies, and insurance companies.

Under the prior federal regulations, the classification of a "business entity" (i.e., a separate entity for federal tax purposes which was not treated as a trust) was based on the historical differences between a partnership and a corporation under state law and focused on the presence or absence of the following corporate characteristics:

- Continuity of life
- Centralized management
- Free transferability of interests
- Limited liability

An entity that had three or more corporate characteristics was generally classified as a corporation while an entity that had fewer than three corporate characteristics was generally classified as a partnership.

The new federal regulations generally classify each business entity as either a "corporation per se," treated and taxed as a corporation, or an "eligible entity" entitled to elect its classification. Any "eligible entity" that fails to make a proper election will be classified according to default classification rules. The default classification rules would classify an eligible entity with two or more owners as a partnership and disregard an eligible entity with one owner.

The new federal regulations provide that the following entities will be treated as a "corporation per se" and always will be taxed as a corporation (subject to specified grandfather rules):

- A business entity organized under a federal or U.S. state statute, *if* the statute describes or refers to the entity as incorporated or as a corporation, body corporate or body politic;
- A business entity organized under a U.S. state statute, *if* the statute describes or refers to the entity as a joint-stock company or joint-stock association.
- An insurance company.
- A state-chartered business entity conducting banking activities, *if* any of its deposits are insured under the Federal Deposit Insurance Act, or a similar federal statute.
- A business entity wholly owned by a state or any political subdivision thereof.
- A business entity that is taxable as a corporation under any other provision of the IRC (such as a publicly traded partnership).
- Any foreign entity specifically listed in Treasury Regulation Section 301.7701-2(b)(8).

All entities not included in this list (whether domestic or foreign, incorporated or unincorporated) are treated as "eligible entities" and are entitled to elect their classification as follows:

- If the eligible entity has at least two members it may elect to be classified and taxed as either a partnership or a corporation; or
- If the eligible entity has only one member it may elect to be classified as a corporation or to be disregarded as an entity separate from its owner.

Thus, for **federal** purposes, a corporate-owned single-member LLC which checks the "non-corporate" box is "disregarded" and effectively disappears for tax purposes

becoming a division or branch of its corporate parent. An individually-owned single-member LLC which is disregarded is treated as a sole proprietorship.

California law does not incorporate federal regulations in this area, but applies 18 California Code Regulation Section 23038 for business entity classification purposes. Under these regulations, California classification results are analyzed in a similar manner, and similar results are produced, as under the prior federal regulations. California classification regulations do not provide for disregarding the existence of an entity; for California tax purposes, a single-owner entity with limited liability is taxed as a corporation.

State law allows the creation of LLCs. An LLC is a new form of hybrid unincorporated business association which affords its members:

- limited liability to the extent of a member's equity investment;
- flexible management alternatives; and
- liberal membership qualification requirements.

LLCs combine traditional corporate and partnership characteristics. Members of an LLC are afforded the same advantage of limited liability as are shareholders of a corporation.

Since 1994, **state law** has allowed the formation and operation of LLCs in California. Any person not prohibited by the LLC Act may file articles of organization with the Secretary of State and execute an operating agreement to organize an LLC, which must consist of at least two members. **State law** also legally recognizes foreign LLCs and permits them to register to conduct business in California. However, the single member LLC is taxed as a corporation.

If an LLC is classified as a partnership for California tax purposes, it is required to pay an annual LLC tax of \$800 and an annual fee based on its total income reportable to California. All existing partnership tax laws apply to an LLC classified as a partnership, unless otherwise specified.

LLCs that are structured having a predominance of corporate characteristics are classified and treated as corporations. They are subject to the applicable corporate franchise and income taxes, including the corporate requirement to prepay the minimum tax to the Secretary of State.

Under existing **state law**, a business trust, as defined, is classified as a corporation per se.

This bill would conform to the federal entity classification regulations (check-the-box regulations). This would be accomplished by directing FTB to adopt comparable regulations and by repealing current business trust law, which mandates that a business trust be taxable as a corporation (unlike federal law where a business trust might be classified as either a partnership or an association taxable as a corporation). The bill generally would provide that whatever classification is adopted for federal purposes also must be used for California purposes.

This bill would provide "grandfather" rules for business entities that were properly classified as associations taxable as corporations for California tax purposes for any income year beginning within the 60-month period preceding January 1, 1997. Such entities would continue to be associations taxable as corporations until an election is made to be classified or disregarded the same as it is classified or disregarded for federal tax purposes. The grandfather rules would not apply to any entity that during the 60-month period preceding January 1, 1997, was not doing business in California, did not derive income from sources within California, and had no owner who was a resident of California.

This bill would allow a single member LLC formed in another state, but doing business in California, to "check the box" and be disregarded for tax purposes. The owner of the single member LLC would report the income (loss) from the disregarded LLC on a Schedule C, a partnership return or a corporation return depending on the owner's filing requirement. Any tax credits from the disregarded LLC reported on the owner's return would be limited to the excess of the owner's tax liability determined by including income attributable to the disregarded LLC over the owner's tax liability determined by excluding the income attributable to the disregarded LLC. No credit would be allowed if the owner's tax liability determined by including the income attributable to the disregarded LLC is less than the owner's tax liability determined by excluding the income attributable to the disregarded LLC.

This bill would require the disregarded LLC to file an information return and pay the \$800 minimum tax and the graduated LLC fee within three months and 15 days following the close of the owner's taxable or income year. Among other things, the information return would include information necessary to verify the LLC's liability, provide the sole owner's name and taxpayer identification number and consent of the owner to California tax jurisdiction. If the owner's consent is not included, the LLC would pay income tax on behalf of its owner at the highest marginal tax rate.

This bill also would eliminate the definition of a business trust as a corporation, thus allowing such entities to be classified as "eligible entities" taxable as partnerships or corporations.

Policy Considerations

This bill balances the desirable tax policies of conforming to federal law and regulations and simplifying the entity classification rules with the policy of maintaining the current law of taxing single-owner entities.

The new federal regulations were enacted to replace the "business entity tests," which could be manipulated by taxpayers to classify themselves as they wished. Without conformity, increased requests for legal rulings regarding business entity classifications would likely occur.

Implementation Considerations

Implementation of this bill would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

This bill would not significantly impact personal income tax or bank and corporation tax revenues.

POSITION

Support.

The Franchise Tax Board voted at its July 21, 1997, meeting to support this bill.